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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC., *Petitioner,*

v.

UNITED STATES OF AMERICA, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the district court is reported at 341 F. Supp. 647 (70a). The opinion of the court of appeals is reported at 480 F. 2d 184 (5a).

Jurisdiction

The judgment of the court of appeals was entered on June 8, 1973. The petition for a writ of certiorari was filed on August 29, 1973 and was granted on January 21, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Statutes and Authorities Involved

(See Appendix)

Title 11, United States Code:

§ 67a(5)
§ 75a(4)
§ 93a
§ 93j
§ 93n
§ 103(a)(8)
§ 104(a)(1)
§ 104(a)(2)
§ 104(a)(4)
§ 104(a)(5)

Internal Revenue Code, Title 26, United States Code:

§ 3102(a)
§ 3401(a)
§ 3401(d)(1)
§ 3402(a)
§ 6001
§ 6011
§ 6672

Questions Presented For Review

1. Does a distribution in a bankruptcy proceeding pursuant to 11 U.S.C. § 104(a)(2) constitute "wages" which are subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code

2. Assuming *arguendo* that such a distribution is subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the claims of the United States and New York City have been barred because no proofs of claim for the taxes in issue were filed by them in the Bankruptcy Court?

3. Assuming *arguendo* that such a distribution is subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the monies withheld in connection with the distribution be accorded "priority" status pursuant to 11 U.S.C. § 104(a)(2) and (4), "administrative claim" status pursuant to 11 U.S.C. § 104(a)(1), "trust fund" status, or unenforceable "penalty" status?

4. Is compliance with the withholding and reporting requirements of the Internal Revenue Code and the New York City Administrative Code in connection with such a distribution inconsistent with the spirit of economy of the Bankruptcy Act and therefore inapplicable in bankruptcy proceedings?

Statement of the Case

Freedomland, Inc. ("Freedomland") filed a petition for an arrangement under Chapter XI of the Bankruptcy Act in the United States District Court, Southern District of New York on September 15, 1964 (18a). On August 30, 1965, it was adjudicated a bankrupt (18a).

During the statutory filing period for filing claims, 413 claims of $600.00 or less were filed by Freedomland's former employees in its bankruptcy proceeding on account of wages that had been earned by the claimants *prior* to September 15, 1964, the date on which Freedomland filed its Chapter XI petition (30a, 32a). No proofs of claims for withholding, social security, or related payroll taxes relative to these claims were filed by the United States or the City of New York during the statutory filing period, after the expiration of that period, or pursuant to the "bar order" en-

tered in the bankruptcy proceedings which directed all taxing authorities having claims against Freedomland or its Trustee to file their claims with the Trustee's attorney or be "forever barred from making any claim against Freedomland's estate or the Trustee" [Petitioner] (71a).

Freedomland's bankruptcy schedules indicated that it owed $80,000.00 on account of priority wage claims. However, the schedules omitted to set forth the names, addresses, social security numbers, number of dependents or related information concerning the claimants to whom such amount was admittedly due (23a) although it is possible that such information existed in forty-two filing cabinets of Freedomland's records located at a warehouse (54a).

On November 7, 1969, Petitioner moved for an order directing distribution to Freedomland's 413 priority wage claimants without any requirement to: (1) withhold Federal, State or City taxes, (2) pay such taxes to the taxing authorities, (3) file tax returns with the taxing authorities, (4) furnish withholding tax statements to the claimants, or (5) pay any penalties to the taxing authorities for failure to withhold and pay or file tax returns in connection with the distribution (18a, 26a). The order was granted on the ground, *inter alia,* that the withholding/reporting requirements of the taxing authorities were inconsistent with the object of efficient, expeditious, and economical administration of bankrupt estates (36a). Thereafter, on appeal to the District Court, and after an evidentiary hearing in which Petitioner presented evidence that compliance with the reporting and filing requirements of the taxing authorities would be burdensome and expensive (56a, 68a) and that a flat 25% deduction for United States taxes would exceed the amount of tax that would be deducted if official tax tables were used on known exemptions and past income (58a), the District Court concluded that Petitioner should be required to withhold United States but not New York City payroll related taxes in making wage claim distributions even

though the United States had failed to file a proof of claim for such taxes in the bankruptcy proceeding. The District Court also directed that such taxes as were withheld should be accorded "fourth priority" status under 11 U.S.C. § 104(a)(4), and that no tax need be withheld for New York City taxes because New York City's tax law did not become effective until 1966, after the date on which the wage claims accrued. (90a)

At the evidentiary hearing before the District Court, Petitioner presented evidence that in order to comply with what ultimately became the District Court's order, Petitioner would be required to, in addition to New York City tax reporting requirements where applicable, and in connection with the 413 priority wage claimants, assemble the required information from Freedomland's records and

a. Prepare and file Internal Revenue Service Form 941 on which Petitioner would have to report total wages which were subject to withholding, total amounts of taxes withheld, total wages which were subject to social security tax, each priority wage claimant's social security number, name and address, and the total of each claimant's withheld payroll and social security taxes. (See District Court Decision, at 77a, 78a) (57a, 58a);

b. Prepare and file Internal Revenue Service Form W-3 indicating withheld taxes for each quarter. (See District Court Decision, at 78a);

c. Prepare and file Internal Revenue Service Form W-2 for each priority wage claimant indicating federal income taxes withheld, wages paid subject to withholding in the year in question, state and city income taxes withheld, social security taxes withheld, the marital status of each claimant, and the social security number of each claimant. (See District Court Decision, at 79a) (60a).

Evidence was also presented that Petitioner and his accountant would be the subject of inquiry from each wage claimant as to the reason for the deductions (59a).

The District Court's opinion concluded that the preparation of the 941, W-2, and W-3 forms could be prepared by a clerk (See District Court Decision, at 80a) as opposed to an accountant and impliedly that such preparation would not be burdensome or expensive although, to prepare all of the returns, with the required information, the evidence established that 42 filing cabinets filled with records would have to be searched at Underwriters Salvage Company [official auctioneer of the Second Circuit] to locate the required information (56a), that these would have to be cross checked against the 413 proofs of claim on file with the Bankruptcy Court; that Petitioner would have to ascertain the social security numbers of and communicate with each wage claimant, determine their applicable tax exemptions, and thereafter determine Federal, State, and local taxes; that reconciliation schedules would then have to be prepared, summarized, cross referenced, cross footed, and transposed to Form 941; that the W-2 forms would have to be prepared; and that W-2 forms would then have to be furnished to each wage claimant and filed with the taxing authorities (57a, 63a to 66a).

On appeal to the United States Court of Appeals for the Second Circuit, the Circuit Court affirmed in part and reversed in part holding that taxes should be withheld for New York City as well as United States taxes, and that such taxes as were withheld should be accorded "second priority" "trust fund" status under 11 U.S.C. § 104(a)(2) (4a).

Summary of Argument

The Circuit Court held that distributions pursuant to 11 U.S.C. § 104(a)(2) constituted "wages" which were subject to the withholding tax, payroll tax, and reporting

requirements of the Internal Revenue Code and the New York City Code. Petitioner contends that such distributions are not wages, that he is in no sense an employer of priority wage claim distributees, that they are in no sense his employees, and therefore that the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code are inapplicable to priority wage claim distributions. Petitioner further contends that even if this court were to hold that the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code were applicable to priority wage claim distributions, that the monies which he would be required to withhold (1) should not be accorded "priority" claim status pursuant to 11 U.S.C. § 104(a)(2) and (4) because that status applies only to wages and taxes owed by a bankrupt, not to withheld taxes or to taxes which become due after bankruptcy, (2) should not be accorded "administrative claim" status because the taxes in issue do not relate to the preservation or development of the bankrupt's estate, (3) should not be accorded "trust fund" status because this court has ruled that it cannot, and (4) should not be turned over to the taxing authorities because to do so would violate 11 U.S.C. § 93j which proscribes the enforcement of penalties. In any event, Petitioner contends that regardless of the applicability of the withholding tax, payroll tax and reporting requirements to priority wage claim distributions in this proceeding the United States and the City of New York could have filed proofs of claim for such taxes within the applicable filing periods but failed to do so and therefore, that their claims are totally barred. Finally, Petitioner contends that compliance with the withholding tax, payroll tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code are contrary to the spirit of economy of the Bankruptcy Act and unenforceable against a bankruptcy trustee in the absence of a clear Congressional direction requiring compliance.

POINT I

Distributions in bankruptcy proceedings pursuant to 11 U.S.C. § 104(a)(2) do not constitute "wages" which are subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code.

The Circuit Court held that the priority wage claim distributions pursuant to 11 U.S.C. § 104(a)(2) were "wages" which were subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code.* The Circuit Court erred.

When a Bankruptcy Judge declares a dividend pursuant to 11 U.S.C. § 104(a)(2), "wages", as defined in I.R.C. (26 U.S.C.) § 3401(a) are not involved. This follows from I.R.C. (26 U.S.C.) § 3401(a) and 26 C.F.R. § 31.3401(c)-1 (a) and (b) which define 'wages" and the employer-employee relationship which is a condition precedent to the characterization of remuneration as "wages" in terms of a *current* performance of services involving an existing "control" relationship of "employer" over "employee." Neither aspect exists in the bankruptcy trustee-wage claimant relationship. See I.R.C. (26 U.S.C.) § 3401(a) which defines "wages" as a "remuneration * * * for services performed by an employee for his employer * * *," 26 C.F.R. § 31.3401(c)-1(a) which defines the term "employee" to include "every individual performing services", and 26 C.F.R. § 31.3401(c)-1(b) which states that "Generally, the relationship of employer and employee exists when the person

* The New York Administrative Code incorporates the Internal Revenue Code by reference. Accordingly, the analysis which follows is equally applicable to the New York City Administrative Code.

for whom services are performed has the right to control and direct the individual who performs the services * * * ". See also Rev. Rul. 69-136, 1961-1 Int. Rev. Bull., Jan.-June, 252, 253, in which the Internal Revenue Service ruled that payments made after "the employment relationship between the employees and the * * * company * * * was terminated" were not "wages" for withholding, social security, or unemployment tax purposes, and Rev. Rul. 55-520, 1955-2, Int. Rev. Bull. July-Dec. at 393, 394, in which the Internal Revenue Service reached a similar result.

In arriving at its decision that wage claim distributions constituted "wages" for withholding and payroll tax purposes the Circuit Court held that bankruptcy trustees were "employers" under I.R.C. (26 U.S.C.) § 3401(d)(1). It had to reach this conclusion for under the Internal Revenue Code a "wage" cannot exist in the absence of an "employer." Thus, the Circuit Court concluded that bankruptcy trustees were "employers" because they are "the persons having control of the *payment* of * * * wages" inasmuch as "the trustee applies for the order [of wage claim dividend distribution] and has title to the funds to be paid, and * * * he sends the checks out * * * " (10a, ft. n. 4).

Contrary to the Circuit Court's holding, it is the Bankruptcy Judge alone who has the duty to declare wage claim and other dividends whether or not they have been applied for by a bankruptcy trustee. Moreover, and more frequently than not, it is the Bankruptcy Court itself, and not bankruptcy trustees, who send out dividend checks. See 11 U.S.C. §§ 67a.(5) and 75a.(11). See also Rule 308, Rules of Bankruptcy Procedure, *Matter of Stringer,* 244 F. 629, (E.D. N.Y., 1917), *Matter of Prindible,* 115 F.2d 21 (3rd Cir. 1940), and 3A *Collier on Bankruptcy,* 2289, § 65.03 (14th ed. 1940). Under the Circuit Court's own reasoning then, and since "control," not "title" is the test, a bankruptcy trustee could not be an "employer" and not being such, no wage claim distribution that might be made can

rise to the stature of a "wage" for withholding tax, payroll tax, or related purposes.

Notwithstanding some doubts on the subject, the Circuit Court felt constrained to hold that wage claim distributions were "wages" for withholding tax and related purposes, in reliance on *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. denied,* 339 U.S. 965 (1950), *Lines* v. *State of California,* 242 F.2d 201 (9th Cir. 1957), *cert. denied,* 355 U.S. 857 (1957), and *In Re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3rd Cir. 1964). The court's reliance was misplaced.

The *Lines* decision does not deal with Federal taxes, and in any event relies on the *Fogarty* decision, as does *Curtis,* on the questions at issue. *Connecticut Motor Lines* did not even consider the issue. Thus, we are relegated to the *Fogarty* decision which, it is submitted, was in error because it incorporates this Court's definition of "wages" in a social security tax context in reliance on *Social Security Board* v. *Nierotko,* 327 U.S. 358 (1946) notwithstanding that the *Nierotko* case had no Bankruptcy Act overtones. Significantly, in *United States* v. *Embassy Restaurant,* 359 U.S. 29 (1958), when this Court was called upon to define "wages" in a Bankruptcy Act context, it reached a result that was diametrically opposed to the *Nierotko* decision because the Bankruptcy Act was involved. It is for this reason that *Educational Fund of the Electrical Industry* v. *United States,* 426 F.2d 1053, (2d Cir. 1970) referred to in the Circuit Court's decision is also irrelevant to the decision in the case at bar. See *Embassy Restaurant, supra,* in which this Court held:

> "[W]e deal with a statute, not business practice. Nor do we believe that holdings * * * under the NLRA or the Social Security Act are apposite. We construe the priority section of the Bankruptcy Act, not those statutes" (at p. 33).

Since wage claim distributions are not "wages", it follows that they are not the subject of the reporting requirements of the Internal Revenue Code. See I.R.C. (26 U.S.C.) §§ 6001 and 6011.

POINT II

The claims of the United States and New York City are barred because proofs of claim for the taxes at issue were not filed with the bankruptcy court.

The United States and New York City failed to file proofs of claim for the taxes at issue (71a). They failed to file their claims, notwithstanding the following: (1) they were at all times on notice from Freedomland's bankruptcy schedules that Freedomland owed approximately $80,000.00 on account of priority wage claims (23a); (2) they were on notice that under the provisions of 11 U.S.C. § 93n priority wage claimants had a six-month period after Freedomland's first meeting of creditors following its adjudication as a bankrupt in which to file their claims or be forever barred from doing so; (3) they were able to compute the total maximum amount of taxes that would be involved following the expiration of the aforesaid six-month bar period, and could file their claims by obtaining an extension of time in which to compute and file their claims pursuant to 11 U.S.C. § 93 n.

Despite the ability of the United States and the City of New York to file claims, the Circuit Court held that

> "Since withholding tax arises only when wage claims are allowed it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt,* * * * The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholding due by law" (16a).

The Circuit Court erred.

Because of the time bar and extension of time provisions of 11 U.S.C. § 93, it was not impossible for the United States and New York City to file proofs of claim on the total maximum amount of taxes they might be entitled to, with their claims being subject to reduction in the event the wage claims themselves were reduced or disallowed. In addition, if a bankruptcy trustee is in fact obligated to withhold tax and pay payroll related taxes on wage claim distributions, such would constitute a "contingent" and therefore provable debt for which the United States and New York City could and should have filed proofs of claim for their claims to be allowed. See 11 U.S.C. § 103(a)(8) which provides that contingent debts are "provable." Moreover, the concept of a constructively filed proof of claim finds no expression in the Bankruptcy Act. On the contrary, the Bankruptcy Act specifically provides that a proof of claim must be signed and in writing, 11 U.S.C. § 93a., and that "all claims provable under [the Bankruptcy Act], including all claims of the United States and of any state or any subdivision thereof" must be proved and filed as provided for in the Bankruptcy Act or be disallowed. See 11 U.S.C. § 93n., *In Re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3rd Cir. 1964), and *In Re Erie Forge & Steel Corp.*, U.S.D.C., Western District of Pennsylvania, No. 69-83 December 29, 1962 (unreported). See also Rule 302(a), Rules of Bankruptcy Procedure, adopted well after Freedomland's adjudication as a bankrupt but nevertheless according to the Advisory Committee's note, a substantial restatement of 11 U.S.C. § 93a. This rule specifically says that every creditor, including the United States, must file proofs of claim for its claim to be allowed. Finally, the Circuit Court simply ignored the Bankruptcy Judge's "bar order" which provided, *inter alia*, that all taxing authorities having claims against Freedomland's estate or the Trustee arising subsequent to the date on which Freedomland filed its Chapter XI petition were directed to file claims or forever be barred from making any claims against Freedomland's estate or its Trustee (24a, 25a).

The Circuit Court's holding was also in error as a matter of policy because it opens up an avenue to other creditors who might claim a "constructive" claim position, thereby subjecting bankruptcy estates to contingencies that would make the administration of a bankruptcy proceeding extremely difficult.

POINT III

If Freedomland's trustee is directed to withhold taxes in connection with wage claim distributions, such taxes should not be accorded "priority", "administration claim", or "trust fund" status, and should be deemed an unenforceable "penalty".

The Circuit Court held that taxes withheld by Freedomland's Trustee in connection with wage claim distributions were entitled to "second priority" "trust fund" status under 11 U.S.C. § 104(a)(2), but not to "administration claim" status. The Circuit Court erred in according "second priority" "trust fund" status to the taxes in issue. It was correct, however, in holding that the taxes should not be accorded "administration claim" status.

A. Taxes withheld by Freedomland's trustee in connection with wage claim distributions should not be accorded "priority" status.

1. Such taxes should not be accorded "second priority" status.

11 U.S.C. § 104(a)(2) accords "second priority" status to "wages and commissions, not to exceed $600 to each claimant * * *". No mention is made of taxes in this sub-

section although specific provision for taxes is made at subsections (a)(4) and (a)(5) of the statute, clearly indicating a Congressional intent *not* to include taxes in the "second priority" established by the statute.

The Circuit Court reasoned that withholding taxes to be derived from payments made to wage claimants constituted "wages" for the purpose of fitting within the "second priority" established by 11 U.S.C. § 104(a). The problem with this reasoning is that it ignores the decision of this Court in *United States* v. *Embassy Restaurant*, 359 U.S. 29 (1958), In the *Embassy Restaurant* case this Court held that the priority sections of the Bankruptcy Act were to be interpreted without reference to other statutes; that payment to a third party on behalf of a wage claimant by a bankruptcy trustee would not constitute part of a wage claimant's "wage" within the scope of the second priority of 11 U.S.C. § 104(a); that to be a "wage" a payment must have the common attribute of a "wage"; and finally, unless "it is clear that [the payments] satisfy the purpose for which Congress established the priority * * * [viz.] to provide the workman a 'protective cushion' against the economic displacement caused by his employer's bankruptcy" (at p. 33) the payments could not constitute 'wages' within the scope of the "second priority." In explaining the policy behind the "wage claim" priority, this Court also held that

> "[T]he purpose of Congress has constantly been to enable employees displaced by bankruptcy to secure, with some promptness, the money directly due them in back wages, and thus to alleviate in some degree the hardship that unemployment usually brings to workers and their families" (at p. 32),

and it reached the conclusion that

> "It is therefore evident that not all types of obligations due employees from their employers are recorded by Congress as being in the concept of wages, even though having some relation to employment." (at p. 32)

See also *Joint Industry Board* v. *United States*, 391 U.S. 224, (1968)

In view of this Court's decision in the *Embassy Restaurant* case, it is difficult to see how the Circuit Court could conclude that withholding taxes were the equivalent of wages. The Bankruptcy Act does not view the two as equivalent; taxes certainly do not have the common attributes of wages; and most significantly, by reducing the amount of money made immediately available to all workmen, viewing the two as equivalent cannot enhance the protective cushion that Congress sought to establish. Moreover, to be consistent, the Circuit Court would also have to have concluded that taxes withheld in connection with pre-bankruptcy wage payments but not turned over to the taxing authorities, also constituted wages, a result which would be directly contrary to 11 U.S.C. § 104(a)(4) which establishes a "fourth priority" for unpaid taxes.

2. Such taxes should not be accorded "fourth priority" status.

11 U.S.C. § 104(a)(4) accords fourth priority status to

> "taxes which became legally due and owing by the bankrupt to the United States or to any State or subdivision thereof * * *"

Taxes withheld by a bankruptcy trustee in connection with wage claim distributions do not constitute "taxes which became legally due and owing by the bankrupt" or at the date of bankruptcy. By virtue of I.R.C. (26 U.S.C.) § 3402(a), such taxes can only be withheld when payment of "wages" is made. Accordingly, when a wage claim distribution is being made, it follows that the bankrupt owed, but

had not paid wages, and withholding taxes were not and could not have been due and owing by the bankrupt or at the date of bankruptcy, although a contingent tax indebtedness may have existed on the date of bankruptcy. See also 26 C.F.R. § 31.3402(a)-1(b) which provides that

> "The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages *as and when paid* • • •" (emphasis supplied).

and the similar requirement imposed by N.Y. Admin. Code § T46-12.0.

Further evidence that no priority status should be accorded the claims of the United States and the City of New York is found in the 1966 amendments to 11 U.S.C. § 104(a)(4) which added among other things the words "which became" between the words "taxes" and "legally due and owing" so that the revised section accords priority status to

> "taxes *which became* legally due and owing by the bankrupt • • • which are not released by a discharge in bankruptcy; *Provided, however,* that no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority • • •" (emphasis supplied).

Thus, taxes arising *after* bankruptcy, not being included in the fourth priority, must be relegated to general unsecured claim status. As explained in House Report No. 687, 89th Congress, 1st Session

> "The committee believes that limiting tax priority to those taxes which became due and owing within three years *preceding* bankruptcy adequately safeguards the public interest in the collection of revenues • • •" (emphasis supplied).

B. Taxes withheld by Freedomland's trustee in connection with wage claim distributions should not be accorded "administration claim" status.

The Circuit Court was correct in rejecting the holding in *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947) insofar as that decision held that taxes withheld by a bankruptcy trustee should be allowed and classified as an expense of administration. Almost every other decision with the exception of *Fogarty* and *Lines* v. *State of California,* 242 F.2d 201 (9th Cir. 1957), *cert. den.,* 355 U.S. 857 (1957), has held in analogous situations, directly and by implication, that taxes withheld by a bankruptcy trustee in the distribution of wage claims cannot constitute an administration expense under the Bankruptcy Act. See *In Re John Horne,* 220 F.2d 33 (7th Cir. 1955); *Pomper* v. *United States,* 196 F.2d 211 (2d Cir. 1952); *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3d Cir. 1964).

The reason why taxes withheld in connection with wage claim distributions cannot constitute an administration expense under the Bankruptcy Act is that an expense accruing during bankruptcy is a cost of administration only if it relates to the preservation or development of the bankrupt's assets. See *e.g., Adair* v. *Bank of America Assn.,* 303 U.S. 350 (1938). Thus, non-tax expenses such as rent accruing after a bankruptcy petition is filed and taxes incurred by a debtor-in-possession can be accorded administration claim status. On the other hand, a tax which becomes due after bankruptcy does not automatically entitle it to first priority status when the activity giving rise to the taxes took place before bankruptcy and had no connection with the development or preservation of the bankruptcy estate. See, *e.g. Philadelphia & Reading Coal & Iron Co.* v. *Van Deusen,* 103 F.2d 869 (3rd Cir. 1939) *cert. den. sub nom. Olley* v. *Philadelphia & Reading Coal & Iron Co.,* 308 U.S. 560 (1939). Nor can they be said to be costs of distributing assets since they are income taxes imposed on the

employees rather than taxes imposed on the act of distribution. Moreover, it is illogical to give employees' taxes a higher priority than "second priority" wage claims which determine the amount of taxes. And, where an estate is insufficient to pay any part of the second priority claims, first priority status for the taxes would be meaningless because no taxes would be due until the wages were actually paid See I.R.C. (26 U.S.C.) § 3402(a).

C. Taxes withheld by Freedomland's trustee in connection with wage claim distributions should not be accorded "trust fund" status.

The Circuit Court held that the taxes in issue were to be accorded second priority "trust fund" status, presumably avoiding thereby this Court's decision in *United States* v. *Randall,* 401 U.S. 513 (1971). As indicated above, the Circuit Court erred in according the taxes in issue second priority status, and finding that the wage claim distributions involved were taxable. It is submitted that in creating a trust it erred again, and that "trust fund" status runs directly contrary to this Court's holding in *Randall* in which this Court said:

> "We think the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets" (at p. 517).
>
> * * *
>
> To allow [trust fund claim] would * * * run counter to the grain of the Bankruptcy Act" (at p. 517).

See also *Nicholas* v. *United States,* 384 U.S. 687 (1966).

The Circuit Court's decision also creates an anomaly in its attempt to distinguish the *Randall* decision. *Randall*

held that where wage claims were actually paid during a Chapter XI proceeding as an administration expense, the tax which should have been withheld did not fall into the same priority status under the Bankruptcy Act as the wage claim itself; whereas the Circuit Court held that where the wage claims have not been paid, that they do.

D. The imposition of a withholding tax requirement upon Freedomland's trustee would constitute the imposition of a penalty which could not be enforced under the Bankruptcy Act.

I.R.C. (26 U.S.C.) § 6672 provides that any "employer" who fails to collect withholding taxes or pay it over to the government in connection with the payment of "wages" will

> "* * * be liable to a *penalty* equal to the total amount of the tax * * * not collected, * * * and paid over" (emphasis supplied).

See also N.Y.C. Admin. Code § U46-35.0(g). 11 U.S.C. § 93j disallows

> "Debts owing to the United States or to any state or any subdivision thereof *as a penalty* * * * except for the pecuniary loss sustained by the act * * *" (emphasis supplied).

In the event Freedomland's Trustee were to make a wage claim distribution without withholding taxes, he would be subjected to a penalty claim for the amount of withholding taxes he failed to collect. Inasmuch as the United States and the City of New York could collect the non-withheld taxes due them directly from the wage claimants involved they would not sustain any pecuniary loss by virtue of the Trustee's non-collection of withholding taxes. Therefore, they would fail to come within the exception of 11 U.S.C. § 93j and their claims would be barred as being equivalent to a "penalty."

POINT IV

The Bankruptcy Court's ruling that "compliance with withholding and reporting requirements of the taxing authorities is utterly inconsistent with the spirit and letter of the Bankruptcy Act" was not clearly erroneous and should *not* have been reversed.

The Bankruptcy Court held that

> "To apply the *Fogarty Rule* [that a trustee must make withholding tax deductions on wage claims distributions] in every bankruptcy case would impose a further burden on the administration of those estates which is entirely inconsistent with the object of efficient, expedient and economic administration of bankrupt estates" (36a).

The Bankruptcy Court further held that

> " * * * compliance with withholding and reporting requirements of tax authorities is utterly inconsistent with the spirit and the letter of the Bankruptcy Act" (37a).

The Bankruptcy Court's holdings, based on the facts of the instant case, the Bankruptcy Referee's knowledge of the extensive bankruptcy records on file in this proceeding, his intimate knowledge of and expertise in bankruptcy matters, and his adoption by implication of Referee Hiller's factual conclusion in a law review article appended to the Bankruptcy Court's decision, *inter alia,* that "trustees usually have no training in payroll accounting and need accounting services, whose cost is borne by unsecured creditors", was not clearly erroneous. Therefore, the Bankruptcy Court's decision should not have been reversed. See General Orders in Bankruptcy, No. 47. Compare Rule 810, Rules of Bankruptcy Procedure. In fact, the Bankruptcy Court's findings were substantiated at the evidentiary hearing conducted by the District Court.

The Bankruptcy Court's findings must be interpreted in light of the historic development of the Bankruptcy Act which demonstrates an overriding concern with the necessity for reducing administration expenses. See 3A *Collier On Bankruptcy* 1429, § 62.05 (1) and 1396, § 62.02 (1) (14th ed. 1940). Therefore, as held by the Bankruptcy Court, a requirement that Freedomland's Trustee withhold taxes on wage claim distributions and prepare tax and related returns and reports would involve an expense having no benefit to creditors as a whole, and would violate the "spirit of economy" of the Bankruptcy Act. Accordingly, the Bankruptcy Court ruled that in the absence of a clear Congressional direction to the contrary, a bankruptcy trustee should not be required to perform such a function. Compare *In Re Berneddy's, Inc.,* 108 F. Supp. 183 (D.C. Mass., 1952), *aff'd sub nom. Commonwealth of Massachusetts* v. *Widett,* 204 F.2d 512 (1st Cir. 1953) in which a Bankruptcy Trustee was exempted from preparing state employment reports on grounds of "economy."

The District Court's decision amply illustrates the burdens that the Bankruptcy Referee referred to in the application of the *Fogarty Rule.* It readily admitted that the *Fogarty Rule* would require the Trustee to prepare all of the federal and city computations, forms and documents referred to earlier in this brief in connection with the 413 wage claimants involved in this proceeding.

The District Court concluded, and the Circuit Court concurred, that the computations and forms could be prepared, by a clerk (See District Court Decision, at 80a), as opposed to an accountant and therefore that such preparation would not be burdensome. The facts, discussed elsewhere in this brief, conclusively demonstrate otherwise. See pp. 4 and 5, *supra.*

One of the reasons why the District and Circuit Courts ruled that preparing the forms was not burdensome was the existence of a "25% rule", *i.e.* a rule that 25%, or in the case of New York City taxes, 1%, is automatically deducted in lieu of using wage claim tables, thus simplifying computations. The District Court called this a rule, but no evidence exists in the record that such a rule exists, or that any basis in law or regulation exists for applying such a rule.

Petitioner submits that compliance with the withholding tax, payroll tax and reporting requirements of the Internal Revenue Code and New York City Administrative Code are in fact burdensome and expensive. Were this not a bankruptcy proceeding, the burden and expense would be irrelevant to petitioner's legal obligations. But the fact is that this is a bankruptcy proceeding and the requirements of the Internal Revenue Code and the New York City Administrative Code must be viewed in that light. The policy and letter of the Bankruptcy Act require that bankruptcy proceedings be administered economically and expeditiously, especially in a case such as this where the United States and the City of New York can collect their just due from the wage claimants themselves without imposing a costly burden on Freedomland's estate. No substantial reason exists why all of the other creditors of Freedomland's estate should have to subsidize the United States and the City of New York in their tax collection endeavors, which in any event are of little benefit to the taxing authorities involved. For as stated in the Brookings Institution's report on bankruptcy, Stanley & Girth, *Bankruptcy, Problem, Process, Reform*, 131 (Brookings Institution, 1971):

> "[T]he point is clear: The federal tax priority has a miniscule effect on federal revenues but a major effect on dividends paid to unsecured creditors in bankruptcy cases. Repeal of such priority is recommended * * *.

CONCLUSION

The Circuit Court's order should be reversed and the Bankruptcy Court's order should be reinstated.

Respectfully submitted,

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